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International Economic & Energy Weekly

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31 August 1984

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Comments and queries regarding this publication are welcome. They may be directed to [redacted] *Directorate of Intelligence,* [redacted] [redacted] 25X1 25X1 25X1

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International Economic & Energy Weekly [redacted]

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Synopsis

1 **Perspective—*The Changing West German–East German Relationship*** [redacted]

A unique bilateral economic relationship has allowed East Germany to derive significant benefit from West Germany over the last 35 years despite often-bitter political relations. Bonn's recent guarantee of an untied financial credit for East Germany and East Berlin's subsequent easing of travel restrictions reflect efforts by both governments to improve intra-German relations at a time of heightened East-West tensions. [redacted] 25X1 25X1

15 **USSR-OPEC: Bilateral Oil Arrangements** [redacted] 25X1

The prolonged soft oil market has led some OPEC members to conclude oil-barter deals with the USSR, adding even more crude oil to an already glutted market. The volume of oil involved, however, is too small to affect world oil prices significantly, and the deals offer little political leverage to Moscow. [redacted] 25X1

19 **Prospects for NATO Defense Spending** [redacted] 25X1

Despite the 1978 commitment by NATO members to increase defense expenditures by 3 percent annually, the non-US NATO average has been only 2 percent. The sluggish recovery in Western Europe almost certainly will curb defense spending, thereby increasing pressures on the United States to compensate for the reduced readiness of the European Allies. [redacted] 25X1

25 **Soviet and US Gross National Products, 1960-83** [redacted] 25X1

Although the Soviet economy did not achieve its goal of outperforming the American economy by 1981, it was slowly gaining ground until the mid-1970s. Thereafter, the relationship between the growth paths shifted in favor of the United States as Soviet growth slowed. [redacted] 25X1

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[redacted] 25X1

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31 August 1984

Perspective

The Changing West German–East German Relationship [redacted] 25X1

A unique bilateral economic relationship has allowed East Germany to derive significant benefit from West Germany over the last 35 years despite their often-bitter political relations. Bonn's recent guarantee of an untied financial credit for East Germany and East Berlin's subsequent easing of travel restrictions have once again focused international attention on improving relations between the two Germanys. While the overall economic relationship is important in itself, the West Germans, in particular, view economic ties as a means to pursue broader improvements in intra-German relations at a time of heightened East-West tension. [redacted] 25X1

The Kohl government—contrary to the tough negotiating stance demanded by the Christian Democrats while they were in opposition—guaranteed the first loan a year ago without demanding specific concessions from the East. [redacted] 25X1

Criticism of last year's deal from Kohl's conservative supporters increased pressure on Bonn to obtain a quid pro quo from the Honecker regime this year. This largely explains Bonn's insistence on an easing of travel restrictions by East Berlin—and, even more importantly, a public announcement of the terms. While these concessions appear meager to conservative critics, they expand the opportunities for contacts between Germans living in the two states. [redacted] 25X1

East German gains from the relationship have been principally financial, and East Berlin sought the loan even though its economy is improving. A third straight year of a hard currency trade surplus, declining foreign debts, and increased reserves have contributed to a resurgence in interest among Western bankers in lending to East Germany. Indeed, East Berlin's stronger economic position enabled it to keep its political concessions to a minimum—an ironic contrast to what occurred in 1983, when Bonn was in a stronger bargaining position but asked for little. This year's loan provides East Berlin with:

- About 15 percent of the money to repay maturing medium- and long-term debt in 1984.
- An improvement in the maturity structure of East German debt.

- Cheaper medium-term money than East Berlin could have acquired elsewhere, even assuming that they could have found the money elsewhere. [redacted] 25X1

Over the longer term, East German economic gains could be even larger. The credit reinforces banker confidence in the West German "umbrella" and will tend to reduce the cost of new East German borrowing in international credit markets. The deal demonstrates that both German Governments support closer economic ties and could have a spillover effect by encouraging additional financial, trade, and technological agreements. [redacted] 25X1

Bonn is still likely to press for modest political or humanitarian liberalization. This serves the dual purpose of easing the burden of partition on all Germans while keeping alive the idea of a common German nation. Explicit linkages of economic deals to political concessions, however, raises problems in Moscow, evident in this summer's Soviet outbursts in *Pravda* against warming intra-German relations. As a result, East Berlin is likely to stress more strongly the separation of political and economic agreements. Bonn, for its part, has reacted calmly to Moscow's outbursts. The Kohl government almost certainly hopes that its largess will maintain the momentum in intra-German relations despite Soviet pressure on East Berlin to put a greater distance between the "two states in one nation." [redacted] 25X1

[redacted] 25X1

Briefs

Energy

Japanese Crude Oil Imports Up Sharply

Japanese refiners increased their spot purchases of crude oil in July and August in anticipation of an increase in the petroleum tax that becomes effective on 1 September. July crude oil imports totaled nearly 3.8 million b/d, up 10 percent from June and up 13 percent from year-earlier levels. August imports are expected to be nearly 4.7 million b/d or more than 55 percent greater than last year. The tax increase is expected to add about 40 cents per barrel to the cost of oil, according to one corporate planner. Storage cost per barrel is only 20 cents per month. 25X1 25X1

West European Gas Use Rises

West European natural gas consumption rose nearly 14 percent in the first quarter of 1984 compared with year-earlier levels. Gas use was up in nearly all countries, with Italy, France, and West Germany registering gains of 21, 15, and 15 percent, respectively. The residential/commercial and industrial sectors accounted for the bulk of the increased demand. Gas use in electric utilities, however, was up 20 percent, or about 1.4 billion cubic meters. Italy more than doubled gas use for power generation as it tried to cope with excess volumes of Algerian gas that Rome had to purchase under take-or-pay contract provisions. 25X1 25X1

Western Europe: Natural Gas Consumption

	Billion Cubic Meters		Percent Change
	First Quarter 1983	First Quarter 1984	
Total	**71.8**	**81.5**	**13.5**
West Germany	16.2	18.6	14.8
United Kingdom	16.9	18.6	10.1
Netherlands	13.5	15.0	11.1
Italy	9.4	11.4	21.3
France	9.3	10.7	15.1
Belgium	3.3	3.3	0
Austria	1.2	1.5	25.0
Spain	0.7	0.9	28.6
Other	1.3	1.5	15.4

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[redacted]

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Yugoslav Oil Shortages

[redacted]

A fall in crude oil imports limited Yugoslav refinery operations to 75 percent of the goal set for the first half of 1984. Lower refinery production has led to a shortage of oil products and, if it continues, could produce bottlenecks in transportation and other oil-dependent sectors. Hard currency shortages held purchases from the West to less than half of planned levels. Imports from soft currency sources—almost exclusively the USSR—also fell below plan. A senior Soviet Embassy official in Belgrade has acknowledged that Moscow has halted deliveries intermittently to prod the Yugoslavs into fulfilling export commitments to the USSR. [redacted]

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International Finance

[redacted]

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[redacted] 25X1

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Argentine Debt Politics

[redacted]

President Alfonsin's new austerity proposals come amid growing signs that Alfonsin believes he has to reach an accord with the IMF. The new plan—to take effect in September—calls for controlling wage and price increases. The goal is to halve the current 600-percent annual rate of inflation by next year. The proposals complement earlier decisions to reduce the public deficit and speed up currency devaluations. [redacted] 25X1

These moves reflect Alfonsin's awareness of dwindling international support. Banks recently refused to renew a short-term loan, [redacted] 25X1 Meanwhile, opposition Peronists have become increasingly critical of high inflation and mismanagement of debt negotiations but have shown little interest, according to US Embassy reports, in reaching an accord with the government on economic policy. [redacted] 25X1

Even with the new measures, the government still lacks the comprehensive monetary and fiscal policies required for an IMF agreement. Moreover, many officials apparently overestimate the Fund's willingness to make additional concessions and may unrealistically believe that lenders will not confront Argentina if September loan deadlines are missed. Nevertheless, international and domestic pressures may persuade Alfonsin that further delays would be more costly politically than the consequences of austerity and a Fund agreement. He may wait until after meetings of the IMF and the Latin American debtor countries next month, when he will gauge regional backing and press for more concessions from lenders. [redacted] 25X1

Trinidad and Tobago's Worsening Financial Problems

[redacted]

Trinidad and Tobago's foreign payments position could deteriorate rapidly because the government is resisting necessary austerity measures. The economy has been hard hit since 1981 by declines in domestic oil production—the mainstay of the economy—and world oil prices. Moreover, foreign investment in the oil industry is off sharply and some companies are trying to divest themselves of their refinery operations. Trinidad's payments deficit this year is likely to approach $1 billion and will cause further declines in the country's foreign exchange holdings. Reserves in June stood at $1.5 billion, less than half the 1981 level. Despite these problems, the Chambers government faces elections in 1986 and appears unlikely to take the unpopular steps—devaluation in particular—that are necessary to put the country's finances in order and set the basis for reaching an agreement with the IMF. [redacted] 25X1

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Further Lebanese Financial Problems

[redacted]

The Lebanese pound recently has fallen to record lows, 6.5 pounds to the US dollar, because of the country's tenuous political and economic situation and uncertainty over the appointment of a new Central Bank governor. The Lebanese political stalemate has prevented the Cabinet from naming a replacement for Central Bank Governor Shaykh Michel al-Khuri, whose term expires on 7 September. The US Embassy and the press report that the Lebanese Central Bank is selling its scarce foreign exchange reserves to moderate the pound's decline. The Central Bank has been spending on the order of US $20 million a day, but cannot afford to continue doing so. Foreign exchange reserves probably total about $1 billion. The pound has depreciated about 8 percent since the beginning of August and is expected to depreciate to 7 pounds to the dollar by yearend. The fall of the pound adds to the country's problems by increasing import costs without helping exports, because of supply constraints. [redacted]

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Global and Regional Trends

West European Capability for Advanced Jet Engines

[redacted]

We believe that the West Europeans have, or soon will have, equipment for commercial production of single-crystal turbine blades. These blades are largely responsible for the superiority of US aircraft engines and are only used in Pratt & Whitney's latest military and commercial engines. The British and French have announced plans for tests of prototype blades in experimental engines. [redacted] This is the first evidence of a production capability for these blades outside the United States. [redacted]

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Thyssen has contracted to deliver a turnkey facility for manufacturing gas turbine components, including single-crystal turbine blades and vanes, to the Soviets in apparent violation of COCOM prohibitions. Beyond concerns about enhancing Soviet military capabilities, the existence of foreign production capability for single-crystal turbine blades has commercial implications for the United States. West European aerospace companies could increase their ability to compete with US commercial engines or assume a larger more active share in future cooperative ventures with US engine manufacturers. [redacted]

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Economic Motives for Moroccan-Libyan Union

[redacted]

King Hassan's unhappiness with the level of financial assistance from the United States and other Western governments was a major factor in his decision to form the union with Libya. [redacted] t his friendship with the United States has not brought enough assistance to meet Morocco's economic and military needs. The King was irritated by what he sees as a disproportionate gap between US aid to Rabat and US aid to Tel Aviv and Cairo. [redacted] Libya has agreed to provide $980 million to Morocco during the next year. About half will be in cash, with the first $100 million due in early September. The remainder will consist of oil and military materiel,

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including small arms and light armored vehicles. Libya also has agreed to accept 100,000 Moroccan workers over the next two years, as compared with the present level of 20,000. [redacted] Tripoli will purchase $600 million annually in Moroccan agricultural and manufactured goods. [redacted] 25X1 25X1 25X1

Qadhafi's aid package is one of the largest he has ever offered. It would allow Libya to replace Saudi Arabia as Morocco's principal economic benefactor. The aid would help ease Morocco's foreign debt burden and high unemployment resulting from a weak market for Morocco's phosphate and agricultural exports. In addition, Hassan probably hopes to use the Libyan deal as a bargaining chip in obtaining new aid from the West. [redacted] 25X1

Qadhafi gains a secure source of agricultural goods and access to skilled labor. Tripoli can finance its aid commitment to Rabat by selling 100,000 barrels of oil per day. Qadhafi's consistent failure to deliver on past promises of aid, however, suggests that he will again fail to honor his commitments. Any breach of the economic agreements would reduce Hassan's motivation for remaining in the union. [redacted] 25X1

Brazil and Libya Strengthen Relations

[redacted]

Brasilia and Tripoli are seeking to expand their military and economic ties, despite the reluctance of a major Brazilian arms producer to sell additional equipment to Libya. [redacted] Press reports indicate the Brazilian Navy Minister will travel to Libya in September for talks on military cooperation. In addition, the transportation ministers of the two countries are to meet soon, and the Brazilian-Libyan mixed commission is scheduled to reconvene in October to discuss cooperative projects. 25X1 25X1

[redacted] 25X1

The recent contacts are likely to lead to new arms contracts, [redacted] Libya traditionally has been second only to Iraq as a market for Brazilian military equipment, and Brasilia is unlikely to jeopardize the relationship. Libya buys relatively inexpensive armored vehicles, ammunition, and other military items from Brazil and already has signed contracts for aircraft and rocket launchers. Brazil also continues to look to Middle Eastern countries for investment capital and probably would welcome Libyan participation in joint economic ventures. [redacted] 25X1 25X1 25X1

Soviet Trade With Non-Communist Countries

[redacted]

The Soviet trade surplus with non-Communist countries continues to grow. During the first half of the year, the surplus was $2 billion, as compared with a deficit of $200 million for the first six months of 1983. Soviet imports from non-Communist countries declined 14 percent, and exports fell 3 percent. The

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decline in Soviet imports results mainly from a drop in purchases of Western machinery and equipment as the Siberia–to–Western Europe gas pipeline nears completion. The value of grain imports also declined as volumes and prices were down slightly from year-earlier levels. The decline in Soviet exports primarily reflects a drop in the value of military deliveries to Third World countries. 25X1

Although the Soviet surplus with the non-Communist countries for 1984 probably will be higher than the $5.9 billion realized last year, the overall improvement is not likely to be as marked as it was during the first half of the year. Recent large orders indicate that Soviet grain imports for the last six months of this year will be substantially higher than the 13 million tons imported during the second half of 1983. Imports of machinery and equipment, however, probably will remain down. In the first five months of this year, Soviet equipment orders totaled less that $500 million, as compared with $6.8 billion in 1982—when large orders for the export pipeline were placed—and $2.2 billion last year. Soviet orders for Western technology and equipment should begin to pick up next year, however, as Moscow firms up projects to be included in the 1986-90 Five-Year Plan. 25X1

East German Trade Surplus With West Germany

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Bonn announced last week that East Germany ran a trade surplus of DM 750 million (about $270 million) with West Germany in the first seven months of 1984. This is a sharp turnaround from a deficit of DM 607 million during the same period a year earlier, when East German imports rose sharply as East Berlin channeled purchases through the intra-German clearing accounts to conserve hard currency for debt repayment. East Germany's current surplus results from a 17-percent drop in East German imports, particularly raw materials and capital goods, and 15-percent export growth. We expect East Germany to maintain its trade surplus with West Germany for the rest of this year as it continues to restrict imports of capital goods and seeks to reduce its preceived "dependence" on West Germany. Bonn reported last month that East German debt declined from DM 4.6 billion in mid-1983 to DM 3.6 billion at the end of June, its lowest level since 1977; East Berlin's use of the interest-free "swing" credit also fell. 25X1

Economic Issues at the South Korea–Japan Summit

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Economic issues, notably Japan's $3 billion a year bilateral trade surplus and the transfer of Japanese high technology to South Korea, will figure prominently in the 6-8 September summit meeting. South Korean President Chun is expected to press Prime Minister Nakasone to enhance the entry of South Korean exports to Japanese markets. Tokyo, however, asserts that South Korea already receives preferential treatment through Japan's generalized system of preferences. Tokyo also maintains that technology transfer is primarily a matter for the private sector to handle. We believe breakthroughs in this area are unlikely, given Japanese industries' growing concerns about competition from South Korea, although the Japanese Government could promise to help transfer selected government-owned technologies. Presummit agreements—an exchange of trade missions and joint research programs—will give Chun some progress to point to, although they also will underscore the slow movement on major issues. [redacted] 25X1

National Developments

Developed Countries

French Government Accepts Citroen Layoffs

[redacted] 25X1

The government's quick decision to allow layoffs by the privately owned Citroen demonstrates Prime Minister Fabius's and President Mitterrand's determination to modernize industry and to improve the financial prospects of business, despite opposition from the Communist-controlled union. The government approved Citroen's plan to reorganize following its acceptance last week by non-Communist workers' representatives. The plan provides 10 months' retraining at 70-percent compensation but will allow only 1,900 layoffs rather than the 2,400 originally requested. Earlier this year the government allowed Citroen to reduce employment by 4,000 through attrition and early retirement but denied the company's request for layoffs. The Citroen plan may be the model adopted by the nationalized giant Renault when it attempts to reduce its work force by 15,000 later this year. [redacted] 25X1

According to the US Embassy, the government's early acceptance of the plan is a direct challenge to the Communist-controlled union, which organized automobile factory sit-ins last spring and called for further negotiations. The government's rapid decision was meant to catch the unions off balance before most workers return from vacation. [redacted] 25X1

West Germany Easing Labor Market Rigidity

[redacted] 25X1

The Kohl government last week proposed legislation aimed at generating jobs by easing labor market restrictions. Expected to become law on 1 January, the measures will reduce limitations on the use of part-time workers, widen employer discretion in setting work hours, introduce new flexibility in hiring and firing, and lift curbs on employment of women and young people. Women will be allowed to work in the building trades, although they still will be excluded from steel mills and mining. Industry officials have welcomed the legislation, particularly proposed changes in a law that currently requires companies to negotiate costly separation payments before laying off workers. Labor leaders and opposition Social Democrats have denounced the proposals as an effort to undermine protection for workers. [redacted] 25X1

Portuguese Tax Reform Initiated

[redacted] 25X1

To comply with the terms of its IMF agreement, Lisbon has created a commission to recommend tax reforms that will broaden the tax base and narrow the budget deficit. Portugal's tax system is a complicated melange of direct and indirect taxes, riddled with loopholes, which facilitate tax evasion. According to the head of the new commission, changes in direct taxes will be aimed at making the system more equitable, simplifying the tax codes, and providing incentives for economic growth. The changes probably will shift a larger share of the tax burden to firms. Because of the complexity of the task, Portuguese officials believe that it will take at least three years to complete all the changes in direct taxes. Under its standby agreement with the Fund, Lisbon must also complete the necessary steps for replacing indirect taxes with the value-added tax (VAT) by the beginning of 1985. Although this will help discourage tax evasion and prepare Portugal for entry into the EC, Portuguese officials would like to postpone introducing the VAT until later in 1985 or 1986 because they are concerned about the effect on prices. [redacted] 25X1

Spain's Economic Performance

[redacted] 25X1

Madrid will come close to meeting most of its 1984 goals, according to recent central bank estimates:

- The Bank of Spain estimates that real GDP growth will reach the government's 2.5-percent target. Most of the stimulus results from export demand. Real exports grew at an annual rate of 20 percent during the first half, largely because of the economic recovery under way in the major industrialized countries. Domestic demand, however, shows signs of weakening, and both private consumption and investment could fall in real terms this year.
- Inflation is running just slightly above the Gonzalez administration's 8-percent target, because of slack domestic demand, smaller wage gains, and a moderation of import prices.
- The current account deficit has improved dramatically. The Bank of Spain projects a surplus of up to $1 billion compared with last year's $2.5 billion deficit. [redacted] 25X1

Madrid's failure to bring the unemployment rate down has been the biggest disappointment. Firms have not begun hiring in response to lower real labor costs, and they may be awaiting the outcome of negotiations between the government, trade unions, and management on wage increases for the next two years and on changes in the social security system. [redacted] 25X1

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Less Developed Countries

More Strikes in Nicaragua

[redacted]

Since the Sandinistas restored the right to strike a month ago, several unions have walked off the job and additional labor unrest is likely. In mid-August, workers in a state-owned brewery struck for four days and were soon followed by some sugar mill and bank employees, according to US Embassy reporting. Other beverage-industry workers lined up at the brewery to show their support for the strikers. The brewers went back to work only after the Minister of Labor threatened to declare the strike illegal and said the government would not agree to any settlement until the strike ended. Despite the Sandinistas' hard line, additional labor unrest seems likely as previous government wage concessions are quickly wiped out by higher inflation. The government probably will be reluctant to crack down on strikers until after the November elections. 25X1

Deepening Economic Problems in the Netherlands Antilles

Economic conditions in the six-island federation of the Netherlands Antilles are steadily deteriorating because of reduced demand for the country's refined petroleum products; petroleum sales contribute 97 percent of the Netherlands Antilles' export earnings. Shell Oil Company has slashed its refining operations to about one-half of capacity, and the Exxon-operated, Netherlands Antilles'–owned Lago oil refinery may close if sales do not pick up soon. In addition new US tax laws are expected to slice government revenues from offshore companies by 30 percent over the next 2 to 3 years. A steep drop in earnings from tourism and ship repair is unlikely to rebound any time soon, because of growing international competition. 25X1

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Only generous Dutch aid will allow the Netherlands Antilles' economy to grow slightly this year. Nonetheless, unemployment in Curacao reportedly is approaching 40 percent and popular discontent is likely to increase. Although at this time we see no serious destabilization threats from Cuba or local leftists, Havana apparently sees the Antilles' economic problems as an opportunity and is increasing business ties and promoting educational exchanges. 25X1

Saudi-US Construction Firm Near Bankruptcy

Carlson al Saudia, one of the largest construction firms in the kingdom, closed its doors last week when creditors threatened police action to collect $16.4 million in arrearages. Moreover, Carlson has not paid most of its 2,000 expatriate Asian workers since March. This firm is a joint venture of a US company and a Saudi firm owned by Prince Saud bin Abdulaziz, a son of King Fahd. Prince Saud has refused to bail out the company, and efforts to find another US firm to take over the troubled contractor so far have failed. Although the construction sector of the Saudi economy has been hard hit by budget cuts, Carlson's severe difficulties have resulted from involvement in a $116 million housing project at King Saud University that has been plagued by faulty construction. 25X1

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Thailand Eases Credit Restrictions

Bangkok last week rescinded the 18-percent ceiling on the expansion of commercial bank credit in 1984 to counter mounting domestic criticism of the tight-money policies. The credit controls imposed last January to slow the rapid growth of imports have produced high interest rates, caused the collapse of several finance companies, and resulted in record small business bankruptcies. Earlier this month the government took over the majority interest in the troubled Asia Trust Bank, Ltd. to prevent the liquidity crisis from spreading to the commercial banking sector. 25X1

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Ivory Coast Soft-Peddles Some Austerity Moves

[redacted]

After four years of the worst economic slowdown since independence in 1960, Ivory Coast has decided against imposing further price increases for bread, bus fares, and rents on nationally owned housing units required under its World Bank structural adjustment program. The government acted out of concern over the possibility of adverse popular reaction, according to the US Embassy. 25X1 The IMF and World Bank do not approve of President Houphouet's actions and are likely to push for further austerity measures in future discussions. Economic recovery is not expected to begin until 1986 at the earliest and will require further increases in global prices of coffee and cocoa—the country's two principal exports. [redacted] 25X1

Mozambican Investment Code

[redacted]

Mozambique has announced its first comprehensive investment code since independence in 1975. The law provides tax and import tariff concessions for foreign investors. It also promises that nationalizations will only occur because of exceptional reasons of national security and that there will be just compensation in foreign currency. 25X1 Although the investment code is a step toward encouraging foreign investment, we believe security problems and inadequate infrastructure will continue to limit investment. [redacted] 25X1

Communist

Budapest Closes Major Firm

[redacted]

After a long debate in the Hungarian bureaucracy, the Ministry of Industry announced earlier this month a landmark decision to liquidate a major enterprise because of the company's persistent financial losses. The firm, IGV, makes machines and precision-engineering tools. 25X1 Despite numerous attempts to rehabilitate the company since 1978, it has remained behind in technical development, has experienced frequent production stoppages, and has been unable to service its loans and to pay wages. Budapest's decision calls for IGV's buildings and equipment to be sold to more profitable enterprises. According to press reports, most of the company's 1,300 workers will undergo retraining and be placed in new jobs. [redacted] 25X1

This action is another clear sign that reform advocates currently dominate Hungarian economic policy making. One of the primary goals of the economic reform program has been to break up inefficient firms and transfer labor and capital to more productive activities. Budapest's precarious foreign financial position helped convince the leadership that steps must finally be taken to reach these goals, even at the expense of unemployed workers and factory managers, the latter having long enjoyed the protection of the bureaucracy. Further steps in this direction are likely as the government becomes better at identifying substandard plants, redistributing capital, and shifting labor. [redacted] 25X1

Soviet Leadership Extends Industrial Management Experiment

[redacted]

The Politburo has approved an extension next January of the five-ministry experiment in industrial management to several enterprises in machine building, ferrous metallurgy, food and light industry, and consumer services. The top leadership body in its 23 August announcement noted the need for further "perfecting" of the experiment, but expressed satisfaction with preliminary results in improving fulfillment of contracted sales obligations—a major "success indicator" for participating enterprises. The Politburo also claimed improvements in product quality and productivity, reduced production costs, and more rapid introduction of technological innovation in enterprises under the experiment. The decision to expand the experiment reaffirms the willingness of Soviet leaders to settle for marginal gains through tinkering with wage incentives and success indicators rather than considering more far-reaching reforms. [redacted]

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Cuba Moves To Join International Coffee Organization

[redacted]

Havana is lobbying to join the International Coffee Organization (ICO), apparently to retain access to hard currency markets in Western Europe and Japan. Proposals now before the ICO that could cut nonmember coffee exports to these markets—the destination of most Cuban exports—probably prompted Havana's move. At the same time, membership in the ICO would provide Cuba greater opportunity to forge ties with other coffee-producing LDCs and Western consumers. In the near term, Havana would receive only limited financial gains from ICO membership. Despite Cuba's claim of an intensive drive to boost coffee output, industry analysts expect no more than a gradual expansion of production. We expect Cuba would have to continue importing lower quality coffee for domestic consumption to free supplies to fill the 300,000-bag ICO export quota in 1985 that Cuba is seeking as part of its membership application. [redacted]

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USSR-OPEC: Bilateral Oil Arrangements [redacted]

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The prolonged soft oil market has led some OPEC members to conclude oil barter deals with the USSR, adding even more crude oil to an already glutted market. Although Soviet reexports of OPEC crude contribute to market weakness, the current volumes represent less than 1 percent of non-Communist oil consumption. We estimate that Soviet reexports are averaging about 285,000 barrels per day (b/d) in 1984. About half of this crude goes to non-Communist countries; the rest helps cover Soviet commitments to client states in Eastern Europe. If oil demand begins to rise later this year, as we expect, OPEC's need to barter oil should lessen. Moscow, for its part, is unlikely to be able to exert any substantial political leverage over OPEC members with whom it has special oil-supply relationships. [redacted]

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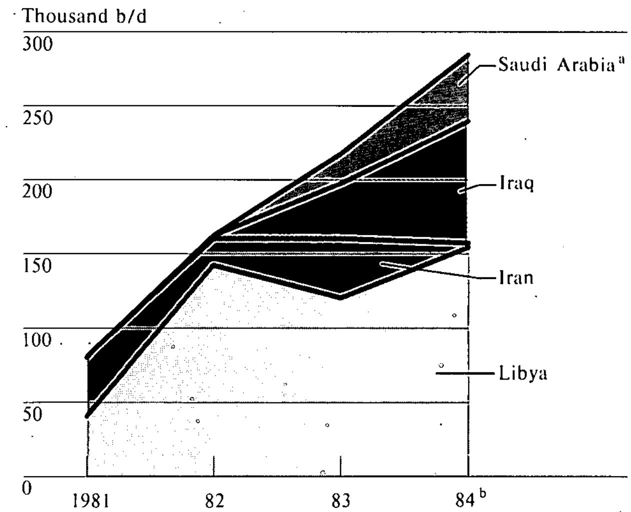
Soviet Imports of OPEC Crude Oil, 1981-84



[a] Saudi Arabia exports crude to the USSR on behalf of Iraq.
[b] First-quarter data.

[redacted]

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Barter Deals

Libya and **Iraq** are currently bartering oil with the USSR. Last year, Libya renewed its oil barter accord with the Soviets, [redacted] The barter arrangement was extended despite the reported efforts of Libyan oil officials to cancel the deal. [redacted] Moscow may have pressed the Libyans for the extension because it needed additional oil to meet existing oil-supply contracts. Several customers complained in the spring of 1983 that the USSR was not fulfilling its oil delivery contracts. [redacted]

[redacted]

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[redacted]

Last year, Moscow also agreed to receive oil from Iraq in return for arms. The USSR received approximately 37,000 b/d of Iraqi crude oil in 1983. During the first quarter of 1984, such deliveries more than doubled, averaging about 82,000 b/d. In addition, the Saudis agreed to pay for some of Iraq's financial obligations to the USSR with deliveries of Saudi crude oil, [redacted] Most of this oil was sent to India—a Soviet customer. The Saudi decision to make oil available on Baghdad's behalf is part of Riyadh's support for Iraq in its war with Iran. According to Soviet trade data, Saudi oil deliveries averaged 20,000 b/d in 1983. Shipments during the first quarter of this year were an estimated 45,000 b/d. [redacted]

More recently, an Algerian diplomat in Moscow told US Embassy officials that **Algeria** is considering bartering crude oil with the USSR. Algiers wants to conclude such an arrangement, presumably before the end of the year, to settle outstanding debts. The volume of Algerian crude to be bartered probably will be substantially less than amounts provided by Libya and Iraq because Algeria's annual payment obligation to the Soviets—mainly for military purchases—is much less. According to the US Embassy, the Algerians are insisting that the crude be bartered at market prices and that it be refined before being sold on the open market. [redacted]

Other Arrangements

Venezuela and **Iran** also have engaged in oil trade with the USSR. Last year, Caracas renewed a 1978 oil-swap arrangement with Moscow. Under this arrangement, the Soviets purchase 20,000 b/d of crude oil from Venezuela, which is then transported by the Venezuelans to Cuba to fulfill Moscow's export commitment. In exchange, the USSR ships an equivalent volume of Soviet crude oil to the Veba oil refineries in West Germany jointly owned by Venezuela and West Germany. This swap arrangement allows both Venezuela and the USSR to save on shipping charges to their customers. The deal lapsed in 1982, when the differential between Venezuela's crude oil prices, set by OPEC, and Soviet prices made the deal disadvantageous for Caracas's European customers. [redacted]

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Although relations with Tehran have deteriorated in recent years, the Soviets continue to purchase some crude oil from Iran. In 1983 the Soviets bought about 40,000 b/d of Iranian crude and reexported over 80 percent of this crude to India to help cover Soviet contract obligations. The remainder was exported to Eastern Bloc countries on the Soviet account. Soviet purchases of Iranian crude dropped dramatically to an estimated 3,000 b/d during the first quarter of 1984, probably reflecting the decline in political relations. [redacted]

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Soviet Reexport Policy

Moscow's willingness to accept oil as a form of payment represents a second-best solution for the USSR. Moscow would prefer to receive cash but is willing to accept oil in order to receive guaranteed receipts for reexports rather than to wait until the financially strapped OPEC nations can repay their debts in hard currency. [redacted]

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Oil sales to hard currency countries are vital to the Soviets, accounting for over 40 percent of the USSR's total hard currency earnings of about $35 billion last year. We estimate that Moscow reexports approximately half of the OPEC oil to hard currency countries. Much of this volume is sent to West European and Caribbean countries. Crude sent to soft currency countries frees up Soviet oil for sale on the Western market. [redacted]

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[redacted] the Soviets resell most OPEC crude under annual contracts to large Western trading companies; the remainder is sold on the spot market. The price of the oil sold under contract is usually based on spot-market prices, and

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when demand is unusually depressed the USSR undercuts spot-market prices to maintain hard currency earnings. [redacted] the price of Soviet oil reexported to Western companies changed monthly in 1982 and 1983 because of market fluctuations. [redacted]

Market Implications

Increased oil trade between OPEC and the USSR is primarily a result of the prolonged soft oil market. Although barter deals will help ease the immediate financial problems of hard-pressed members, excess oil supplies in an already weakened market will exert downward pressure on price. Additional downward price pressure will occur if the Soviets, as they have in the past, reexport the bartered crude at lower spot-market prices. [redacted]

In our judgment, Soviet reexports of OPEC crude currently are too small to cause a substantial price break. If, however, OPEC-member countries continue to barter crude and place an increasing volume of oil onto the market that could otherwise not be sold at official prices, significant downward price pressure could result. According to recent press reports, Iran and Iraq have already agreed to barter additional amounts of crude oil to the West Europeans, notably Greece and France. Cash-short Nigeria reportedly has also expressed interest in bartering crude. [redacted]

If the market remains soft, as we expect, and these deals proliferate, other less cash-hungry OPEC members will be forced to restrain crude output to shore up the current benchmark price of $29 per barrel. We expect that much of this burden would fall on Saudi Arabia, OPEC's swing producer. In July, the Saudis cut production by 1 million b/d below the June level to relieve downward pressure on prices, and lowered production another 200,000 b/d in the last few weeks. [redacted] The willingness of Saudi Arabia to cut production further probably will depend on other cartel members' compliance with their OPEC-assigned quotas. [redacted] 25X1

If demand for OPEC crude oil strengthens in the next several months, hard-pressed cartel members should be able to increase oil exports. As crude oil sales rise, these members should be in a better position to pay their debts in cash and may be less inclined to engage in barter deals with the USSR or other countries. [redacted] 25X1

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Implications for Soviet Political Leverage

While oil-supply arrangements afford the Soviets an opportunity to enhance their economic ties with certain OPEC members, the deals are unlikely to provide Moscow political leverage. In our judgment, the volumes of crude oil involved in these arrangements are too small and the USSR's interest in maintaining economic ties with OPEC members too great to cause the Soviets to manipulate these arrangements for political ends. The Soviets have had little success in using their vastly more significant arms sales to countries such as Libya and Iraq to enhance their political clout. Moreover, the OPEC countries involved in oil-supply arrangements with the Soviets are fiercely independent and probably would react strongly to Soviet attempts to exploit these arrangements for political ends. [redacted] 25X1

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[redacted]

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Prospects for NATO Defense Spending [redacted] 25X1

Budget constraints are limiting the NATO Allies' defense spending, and their military readiness is suffering. Despite the 1978 commitment by NATO members to increase real defense expenditures by 3 percent annually, during 1979-84 the non-US NATO average has been only 2 percent. As a result, many of the Allies have curbed spending on personnel, maintenance, operations, and training to limit the impact on equipment procurement. The sluggish recovery in Western Europe almost certainly will curb defense spending, thereby increasing pressures on the United States to compensate for the reduced readiness of the European Allies. [redacted] 25X1

Pressures on Defense Budgets

In 1978, NATO leaders agreed that 3-percent annual real increases in national defense expenditures were necessary to respond to the continuing growth in Warsaw Pact forces and capabilities. The following year, the Allies entered the worst economic slump in postwar history, which significantly boosted government budget deficits. [redacted] 25X1

One response, dictated by both political and economic considerations, has been to limit defense spending. Overall, non-US NATO defense spending has averaged real growth of only 2 percent since 1978; by contrast, the 1979-84 US average has been about 6 percent. Current spending plans for the Allies call for real growth of about 1 percent in 1984, the lowest since the goal was adopted, although supplemental appropriations and lower-than-expected inflation rates could increase the rate. [redacted] 25X1

Individually, only four NATO Allies—Norway, Canada, Luxembourg, and the United Kingdom—have averaged at least 3-percent real growth in defense expenditures since 1978. Of these, only the United Kingdom is a major force. Moreover, much of the UK's gain occurred in 1982 during the Falklands war. France, Italy, the Netherlands, and Greece roughly matched the non-US NATO average, while recent shortfalls have lowered West German average growth to 1.4 percent. Spending performance has been erratic among the other

NATO: Real Growth in Defense Expenditures [a]

Average annual percent

	1982	1983 [b]	1984 [c]	1979-84 [d]
Non-US NATO	**2.6**	**1.8**	**1.2**	**2.1**
Belgium	−3.3	−3.0	−0.4	−0.3
Canada	4.9	5.0	5.0	3.6
Denmark	−0.3	−0.2	0.4	0.2
France	2.0	0	0.5	2.0
Greece	0.1	−0.3	−0.5	2.0
Italy	3.2	1.1	0.8	2.1
Luxembourg	3.9	3.5	3.1	6.3
Netherlands	1.8	2.7	2.0	2.0
Norway	4.1	2.8	3.5	3.0
Portugal	0.5	0.4	NA	2.4
Turkey	4.6	1.9	1.8	2.5
United Kingdom	6.4	3.1	2.0	3.1
West Germany	−0.9	1.9	0.2	1.4

[a] Defense deflator used where available; otherwise the GDP deflator used. Data derived from official country reporting to NATO; French data derived from NATO and other sources.
[b] Estimated.
[c] Forecast.
[d] Years of the 3-percent goal.

[redacted] 25X1

NATO Allies; several—Belgium, Denmark, and Turkey—have met the goal only once or not at all in the past six years. [redacted]

The shortfall in the procurement of military goods and services not purchased is hard to overcome. The aggregate shortage during the period 1979-84 amounts to about $11 billion. To make up for such losses, the Allies, as a group, would have to boost 1984 real defense spending by 11 percent over planned levels. In dollar value, the West German shortfall accounts for slightly more than half the total. Bonn would have to increase the defense budget by almost 30 percent to offset the $6 billion in accumulated lost spending. While the other countries' foregone purchases are much smaller than West Germany's in nominal terms, many are significant relative to their defense budgets. For example, half of the remaining countries have shortages equal to 10 percent or more of their 1984 budgets; Belgium and Denmark are the worst, with well over 50 percent each. [redacted]

Competition From the Social Sector

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Domestic pressure to cut already slim defense budgets comes from the rising burden of social welfare costs. Given Western Europe's political commitment to an extensive social welfare system, the sharp increase in unemployment in the past few years has caused the costs of such programs to rise sharply. Unemployment in the non-US NATO countries soared from 5.5 million in 1973 to 19 million in 1983, the highest level since the Great Depression. Higher expenditures and recession-induced tax losses have pushed government budget deficits to record levels. [redacted] 25X1

Social welfare expenditures have increased since 1970 from about 20 percent of GDP to roughly 25 to 30 percent in most of the major European NATO countries. For most countries, on the other hand, defense expenditures have rarely topped 5 percent of GDP and have generally hovered around 3 or 4 percent for well over a decade. Even though 25X1

Selected NATO Countries: Total Defense Expenditures and the 3-Percent Goal, 1979-84

	Billion 1983 US $			Difference as a Share of 1984 Budget (*percent*)
	3-Percent Goal	Actual	Difference	
Total	**463.9**	**452.6**	**−11.3**	**11**
West Germany	135.9	129.8	−6.1	28
Canada	36.9	36.6	−0.3	4
Norway	9.9	9.8	−0.1	6
Portugal	4.0	4.1	0.1	0
United Kingdom	138.6	138.6	0	0
Greece	13.7	13.1	−0.6	26
Belgium	18.1	16.6	−1.5	56
Italy	57.6	56.6	−1.0	10
Denmark	9.2	8.4	−0.8	57
Turkey	14.4	14.2	−0.2	8
Netherlands	25.6	24.8	−0.8	18

[redacted] 25X1

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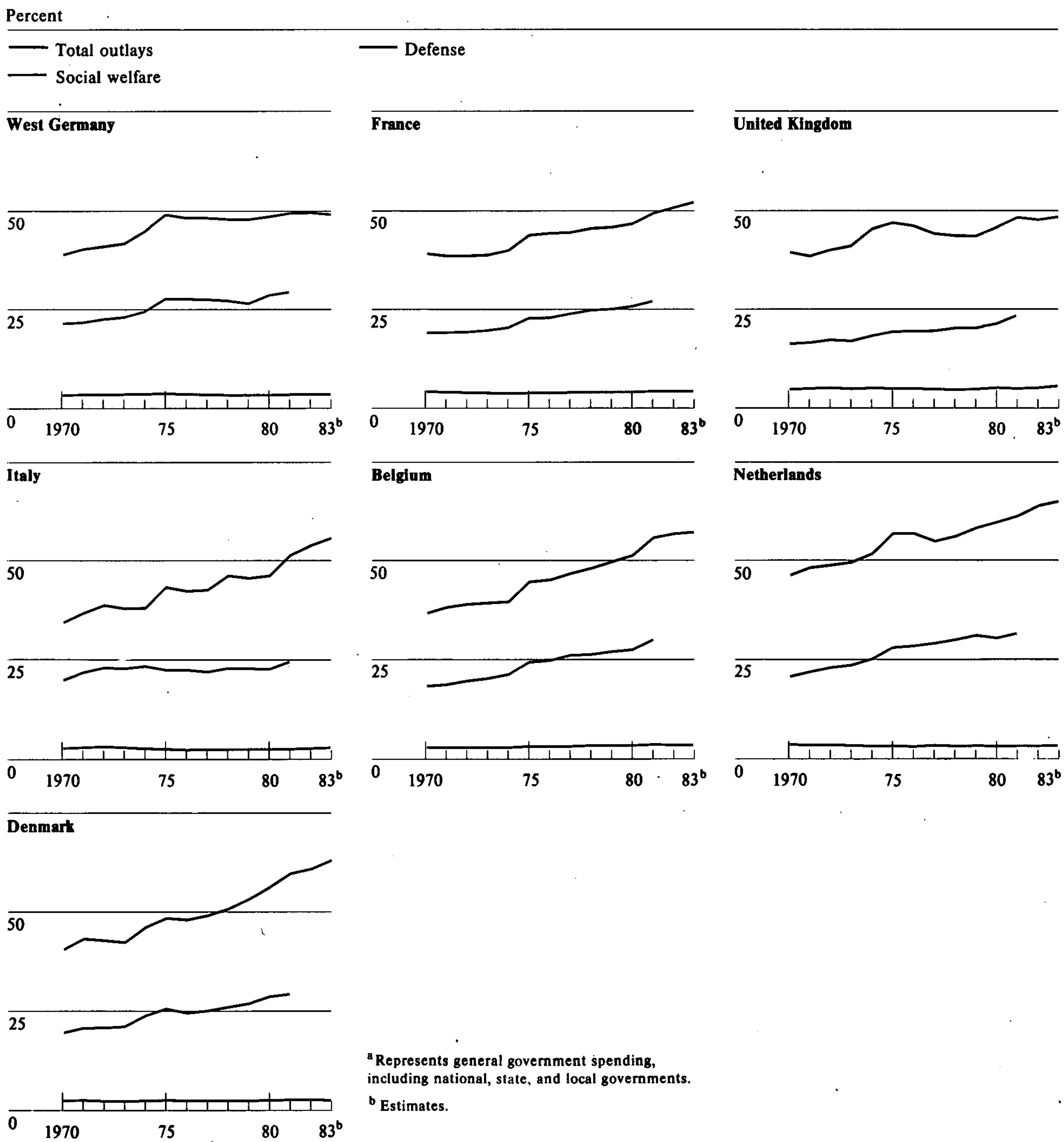
Selected Countries: Government Spending[a] as a Share of GDP



[a] Represents general government spending, including national, state, and local governments.
[b] Estimates.

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defense spending is not a major factor in the overall budget crunch in Western Europe, public opinion polls have consistently shown strong sentiment for defense reductions as the first step in cutting budget deficits. Even limited social cuts or higher taxes have proved politically difficult.

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Impact on Defense

Faced with rising costs and constrained budgets, many of the Allies have turned to major reductions in personnel, maintenance, current operations, and training as their chief means of controlling defense spending:

- Personnel expenditures, as a share of non-US NATO-wide defense budgets, have declined from 54 percent in 1975 to less than 47 percent in 1983. Several countries—particularly France, the Netherlands, the United Kingdom, and Norway—have reduced military and civilian manpower and are relying more heavily on reserves.

- All NATO Allies have curtailed training and many have canceled or trimmed field exercises. In several countries, laws governing military unions have forced an increase in the already high costs of troop training. The Danish Navy, for example, has limited training at sea because of overtime compensation requirements for sailors. To reduce fuel usage, pilot flying hours also have been severely limited in Belgium, the Netherlands, and Italy.

- To reduce operational costs, the Allies have phased out older weapon systems early to save on maintenance and have limited replenishment of spare parts and ammunition stocks.

Most Allies have attempted to protect equipment procurement programs; as a result, procurement increased from less than 14 percent of their combined defense budgets in 1975 to 21 percent in 1983. Nevertheless, a number of major projects have been canceled, and many more have been stretched out. In general, the Allies failed to meet their 1983 equipment goals established in 1978.

No Relief in Sight

We expect political and economic pressure on NATO defense budgets to increase during the rest of the decade. Economic growth almost certainly will be sluggish, unemployment probably will not subside until the early 1990s, and social welfare costs consequently will remain high. Without at least 3-percent real growth in defense spending, many of the Allies' force improvement programs will be further curtailed:

- A recent preliminary study by the Supreme Headquarters Allied Powers Europe predicted that most countries would achieve less than 70 percent of their 1984-88 force goals. Major shortfalls are expected to occur in antitank helicopters, mine-warfare ships, submarines, stockpiles of munitions, and air defense missiles.

- Further cutbacks in training for pilots, reserves, and some ground units—already below NATO standards—are likely in a number of countries.

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Implications

The United States could come under increasing pressure to compensate for the Allies' failure to meet their commitments. For example, Greece, Portugal, and Turkey—NATO's poorest members—already are almost totally dependent on foreign military assistance for day-to-day operations as well as force modernization. Among the more likely measures that the Allies could propose are:

- Reductions in host-nation support for US forces in Europe to permit shifts of national funds to procurement.
- Reductions in national contributions to the NATO Common Infrastructure Program.
- Early movement toward an MBFR agreement that would reduce costs through lower force levels.
- More favorable terms on European procurement of US equipment, coupled with significant US purchases of West European arms.

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- Expanded US reinforcement and pre-positioning commitments to offset declines in national forces. [redacted] 25X1

We expect that the economic barriers to a substantial conventional force buildup will not lessen European discomfort over NATO's dependence on its nuclear deterrent. Any debate over NATO doctrine, however, is likely to focus less on nuclear dependence, per se, than on the proper conventional strategy and force mix to reduce it. [redacted] 25X1

As the Allies address these issues, their concerns over the state of US-European defense trade and US restrictions on technology transfer are likely to undercut further their support for an aggressive conventional force modernization effort. Rather, they are likely to emphasize proven systems over unproven technologies and to stress the imbalance in the US–West European arms trade in arguing against major new funding programs. [redacted] 25X1

[redacted] 25X1

Soviet and US Gross National Products, 1960-83 [1]

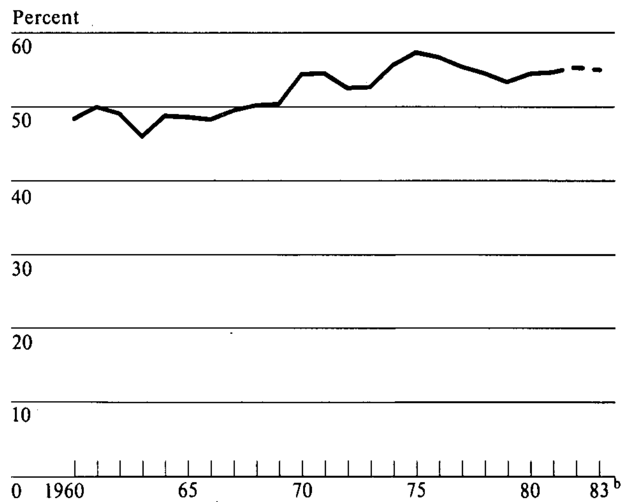
[redacted] 25X1

The CPSU is setting a great task—to achieve in the next 20 years a standard of living higher than that of any capitalist country. . . . In 20 years, the USSR will have almost twice the present industrial output of the entire nonsocialist world. . . . By accomplishing its basic economic task, the Soviet Union will win a world-historic victory in the peaceful competition with the United States.

General Secretary Khrushchev
1961

Although Khrushchev's forecasts have not been realized, the Soviet economy gained on the US economy between 1960 and 1975 as its output rose from 49 to 58 percent of the US total.[2] Between 1975 and the late 1970s, however, it dropped to about 55 percent of the US GNP, and it remained near that level through 1983. [redacted] 25X1

Soviet GNP as a Percentage of US GNP, 1960-83[a]



[a] Measured by calculating the geometric mean of the percentages expressed in 1970 rubles and 1976 dollars.
[b] Preliminary.

[redacted] 25X1

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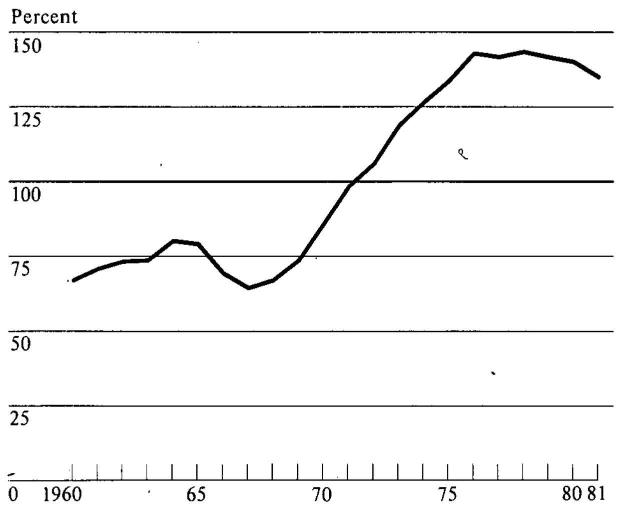
The Soviet Union gained on the United States from the mid-1960s to the mid-1970s because average annual Soviet growth rates during the Eighth and Ninth Five-Year Plans (FYPs) were higher than average US rates during the same periods. Soviet growth, however, had been slowing since at least the mid-1960s, and the relationship between the two economies began to shift in favor of the United States in the 10th FYP (1976-80) as the decline in Soviet growth rates continued while US growth accelerated. [redacted] 25X1

Although the Soviet Union gained ground over the 20 years, the absolute size of the gap produced annually increased, whether measured in rubles or dollars. The US recessions of 1970, 1974-75, 1980, and 1982 caused the gap to lessen in those years, but the trend has been upward, and the gap widened noticeably after 1976. Between 1960 and 1983, US GNP grew 300 billion dollars or 285 billion rubles more than Soviet GNP. [redacted] 25X1

[redacted] 25X1

[2] Geometric mean of comparisons valued in 1976 dollars and 1970 rubles. [redacted] 25X1

Soviet Defense as a Percentage of US Defense, 1960-81[a]



[a] CIA defense comparisons have traditionally been made in dollars or rubles. This figure presents the geometric mean of the two comparisons for consistency with the rest of the figures in this paper.

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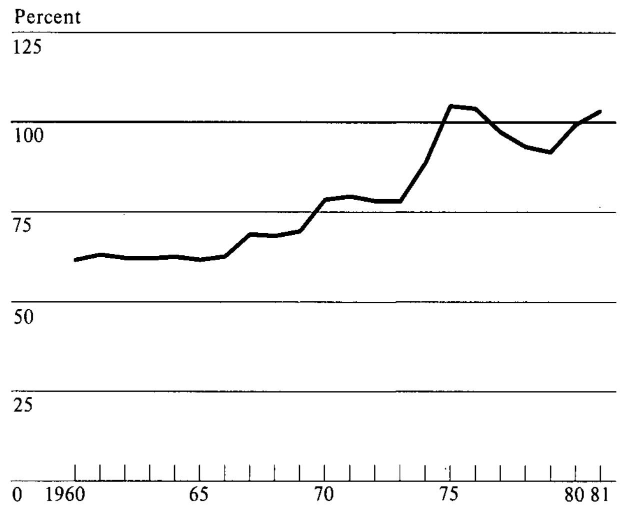
Soviet Investment as a Percentage of US Investment, 1960-81[a]



[a] Geometric mean of the dollar and ruble comparisons.

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Trends in GNP Components[3]

The largest shifts in the uses of GNP between the two countries in the 1976-81 period were in defense and investment. Average annual Soviet growth rates in these areas were markedly lower in the 10th FYP than in earlier periods and were lower than corresponding average American rates.

Defense. The absolute level of the Soviet defense effort has remained substantially above that of the United States since the early 1970s. Real decreases in US defense spending occurred during 1969-76 1976 as the United States disengaged from the Vietnam conflict, while consistent growth pushed total Soviet defense costs to over 40 percent higher than those of the United States by the mid-1970s. The annual rate of Soviet defense growth slowed after 1976, and the defense cost gap remained at the 40-percent level until 1981, when accelerating US defense costs cut the Soviet lead to around 35 percent. 25X1

Defense was also the greatest difference in GNP composition between the two economies. The United States halved the share of GNP going to defense following the Vietnam war—from 10 percent in the early 1960s to 5 percent in the early 1970s. The Soviets, on the other hand, had a fairly steady defense burden estimated at 10 to 14 percent of GNP over the 1960-81 period.[4] 25X1

[3] These estimates were prepared with data ending in 1981. Preliminary estimates for 1982 and 1983 were prepared using rough aggregate indexes.

[4] These burden estimates use a US definition of defense. A Soviet definition probably would include more activities (primarily civil defense and civil space activities, which in the United States would be funded by nondefense agencies). The US defense burden remains nearly the same under either, because the costs of US civil defense and civil space activities are small relative to the defense budget. The Soviet defense burden would increase by 1 to 2 percentage points if a Soviet definition were used. The Soviet definition is appropriate in a noncomparative context when defense resource costs as the Soviets might see them are analyzed. In all cases, however, the only appropriate burden calculation is that in which both defense and GNP are measured in the currency of the given country. 25X1

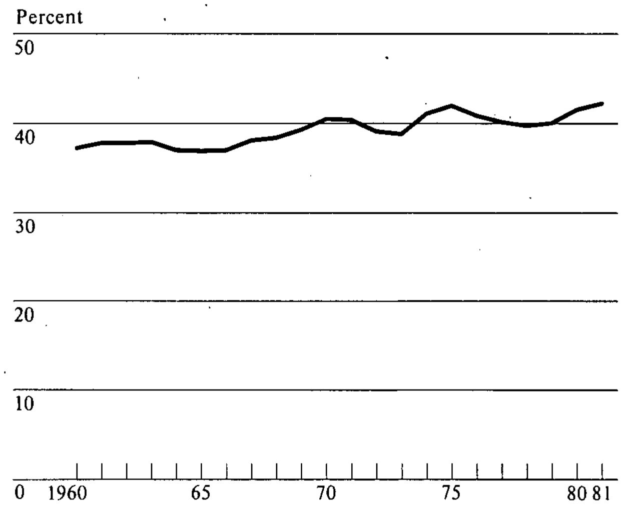
Investment. Total Soviet investment has grown almost twice as fast as that of the United States since 1960, averaging 6 percent annually compared with about 3 percent for the United States. The absolute level of Soviet investment stayed at around three-fifths of the US level through the mid-1960s, rose to four-fifths by the early 1970s, and exceeded US investment in 1975, 1976, and 1981 by a small margin. Even so, the growth rate of Soviet investment has been declining since the early 1960s, and markedly lower growth rates during the 10th FYP were a major factor behind the United States' ability to widen the GNP gap.

Soviet gains in comparative levels of investment were most pronounced in the area of construction. Soviet construction rose from about 60 percent of the US level in 1960 to 120 percent by the early 1980s. The value of the machinery and equipment component also increased relative to that of the United States over the entire period but stayed below the US figure. Underlying these trends is the general tendency in the United States to devote a larger proportion of investment resources to re-equipping older facilities and to incorporate more extensive mechanical and electronic equipment into new facilities.

Since 1960 the USSR has devoted a greater share of its economic resources to investment than has the United States. Soviet investment steadily increased from a low of 21 percent of Soviet GNP in the early 1960s to a high of 30 percent by 1981, while US investment fluctuated between 17 and 20 percent of US GNP over the 1960-81 period. Soviet investment for machinery and equipment (including comparably estimated capital repair) steadily increased from 5 percent of Soviet GNP in 1960 to 13 percent by 1981, while Soviet construction plus comparable capital repair remained between 16 and 18 percent of GNP. In the United States, machinery increased from 5 to only 9 percent of GNP in those years, while construction's share steadily decreased from 12 to 9 percent.

Consumption. The Soviets have gained slightly on the United States in total consumption costs since 1960. Soviet consumption over the period rose from a low of 37 percent of US consumption in the mid-1960s to a high of 42 percent in 1981.

Soviet Consumption as a Percentage of US Consumption, 1960-81[a]



[a] Geometric mean of the dollar and ruble comparisons.

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Within the consumption category, Soviet health expenditures showed the most dramatic change by steadily dropping from 67 percent of US health expenditures in 1960 to 38 percent by 1981. This was a consequence of US health costs rising much more rapidly than those in the Soviet Union. Education costs in the Soviet Union began the period at or above the US level, dropped to 86 percent as US expenditures accelerated in the late 1960s and early 1970s, but returned to an approximately equal level by 1981. In the other consumption categories of food, soft goods, durables, and household services, the Soviets showed small but consistent relative gains.

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The Soviet Union does not have an increasingly service-oriented economy. Its service sector remained relatively steady at 19 to 21 percent of Soviet GNP between 1960 and 1981, while the US service sector increased from 33 to 39 percent of US GNP by 1975 before falling slightly to 37 percent by 1981. In both countries, the share of GNP devoted to durables increased, soft goods consumption remained about the same, and the share going to food decreased. Food consumption as a share of GNP dropped by as much as 7 percentage points in the Soviet Union and by 4 percentage points in the United States over the period.

In terms of per capita consumption, Soviet consumers were less well off than Americans. This is because the Soviet population was 15 to 20 percent larger than the American population over the 1960-81 period. The trends of the per capita and aggregate consumption comparisons are essentially the same, however, because the populations of both countries grew at the same average rate—about 1 percent a year. Soviet per capita consumption rose slightly over the 1960-81 period, from 31 percent of US per capita consumption in 1960 to 36 percent in 1981. As in the aggregate consumption comparison, Soviet health expenditures showed the most change, dropping from 57 percent of US per capita health expenditures in 1960 to 33 percent in 1981. The other categories of education, food, soft goods, durables, and household services showed slight overall relative gains for the Soviets.

Implications

Although the Soviet economy did not achieve Khrushchev's goal of outperforming the American economy by 1981, it was slowly gaining ground until the mid-1970s.

Soviet GNP growth has been on a downward trend since the late 1960s, but this trend worsened in the late 1970s for a number of reasons. Some were beyond the Soviets' control, such as bad weather, unfavorable international economic conditions, and a decline in the growth rate of the working population. Others included aging of the capital stock—which required increasingly larger investments to keep it productive—and mounting shortages of key raw materials and energy sources. Still others were the results of planning decisions, particularly the decision implemented in 1976 to switch from an "extensive" investment policy that expanded production through large increases in capital and labor to an "intensive" policy of growth through more efficient use of resources. Bad investment decisions also led to insufficient resources being devoted to transportation, which created shortages of rolling stock and massive bottlenecks. Finally, some of the causes of the downturn in growth rates may be endemic to the Soviet system of central planning. The planning process, with its emphasis on meeting production quotas, seems to have stifled innovation and creativity, which are vital to productivity. Lack of wage incentives and limited availability of consumer goods have also been drags on productivity growth.

If the US economy continues to perform as well as it has over the last year, the gap between the US and the Soviet economies is likely to widen considerably in the next decade. Forecasters do not agree on whether the United States can sustain this growth, but the consensus of estimates developed by leading private forecasters show average annual growth rates of 3 percent or more through the mid-to-late 1980s. We project Soviet growth below this rate for the rest of the decade. If these projections prove accurate, Soviet GNP in 1990 will be back down to less than half the US figure.

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Honduras: Waiting for Economic Recovery

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Honduras's deep four-year recession appears to be bottoming out, largely as a result of US aid. Nonetheless, a return to the high growth rates of the late 1970s is unlikely to occur any time soon. Living standards have fallen significantly over the last five years. Although there have been few displays of economic-related discontent, we expect increasing domestic criticism of President Suazo's economic management as per capita income continues to fall. The government's unwillingness to take strong but politically risky economic measures—particularly the long-overdue devaluation recommended by the IMF—is likely to delay the return of stronger economic growth.

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The Bleak Economic Record

After four years of real GDP growth averaging 8.5 percent, Honduras experienced a drop in commodity prices in 1980 that sent export earnings into a tailspin, causing economic growth to slump. In addition, a spurt of terrorist activity by the radical left and uncertainty over the shift to civilian rule in 1982 undermined business confidence needed for new investment. Political upheaval in the region, moreover, scared off many potential foreign lenders and investors, encouraging capital flight and further disrupting exports. By the end of 1983, real per capita GDP had dipped 12 percent below the 1979 peak, inflicting especially severe hardships on a country that was already the poorest in Central America.

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All sectors were hard hit. Industrial output was hobbled by falling demand in the steadily disintegrating Central American Common Market and by difficulty in obtaining essential imports of intermediate and capital goods. Bankruptcies soared, particularly in import-dependent businesses. Domestic credit restrictions and cuts in public and private investment expenditures led to a decline in construction. At the same time, agriculture showed only a slight increase. Output of major export crops—coffee and bananas account for nearly half of Honduras's export earnings—stagnated in the face of declining foreign demand. Unemployment rose steadily, and by late 1983 probably averaged between 20 and 30 percent, with an additional 30 to 35 percent of the labor force underemployed.

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In the early 1980s, Tegucigalpa relied heavily on external borrowing to finance its current account and domestic budget deficits. Most of the debt consisted of concessionary loans from multilateral development banks and the United States. In 1982, Honduras turned to the IMF for a 14-month standby loan. In late 1983, the Fund halted further drawings because of the excessive budget deficit and the failure to adopt tariff reforms. Strict import restrictions helped reduce the current account deficit from $317 million in 1980 to $168 million in 1983, but, by the end of 1983, medium- and long-term debt held by the public sector had nearly doubled to $2 billion—equivalent to 65 percent of GDP.

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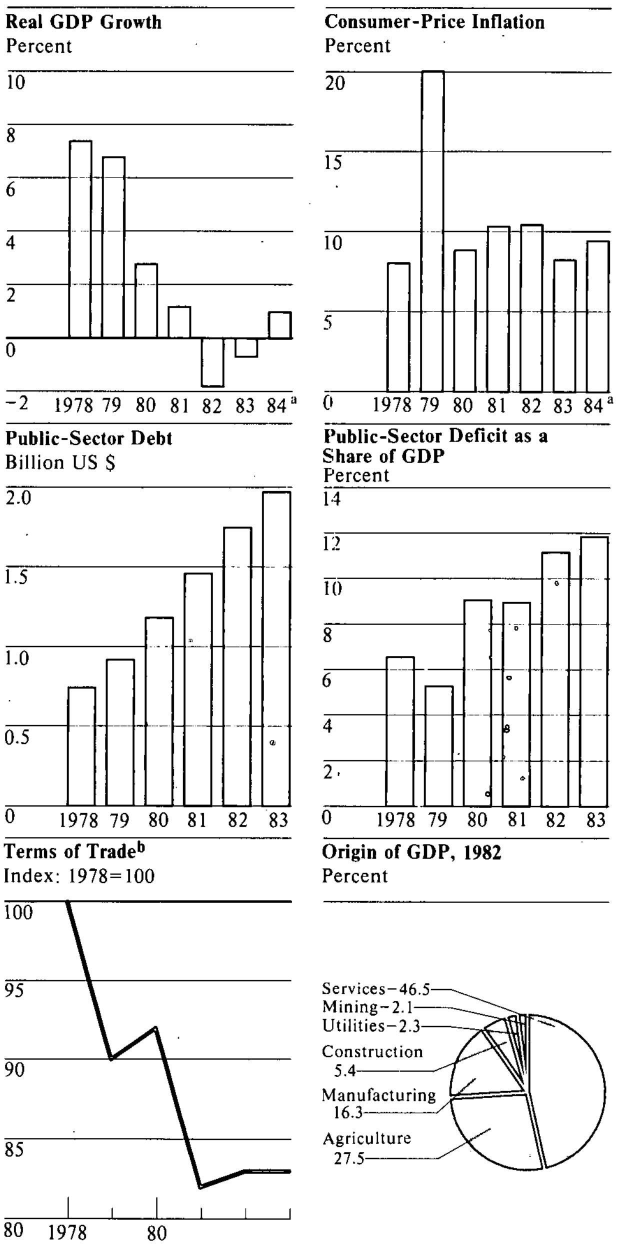
Recent Policy Initiatives and Public Reaction

Serious foreign exchange shortages prompted the legalization in November 1983 of the parallel foreign exchange market and a relaxation of the strict import-control system. Licenses now are granted to importers who obtain foreign exchange outside the banking system, but exporters still must surrender all their foreign exchange earnings to the central bank. Participants in the parallel market

Honduras: Economic Indicators, 1978-84



[a] Projected.
[b] Ratio of export prices to import prices.

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Honduras: Balance of Payments

Million US $

	1982	1983 [a]	1984 [b]
Current account balance	−228	−168	−190
Exports of goods and services (f.o.b.)	784	815	860
Bananas	218	209	220
Coffee	153	151	167
Imports of goods and services (c.i.f.)	1,042	1,028	1,120
Net transfers	30	45	70
Capital account balance	127	151	170
Private capital (net)	−60	−31	−40
Official capital (net)	187	182	210
Change in reserves and errors and omissions	**−101**	**−17**	**−20**

[a] Preliminary.
[b] Projected.

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avoid the two- to three-month delay for imports while paying a premium of about 35 percent for foreign exchange. The parallel market also appears to be financing the import of consumer goods, which had received low official priority. The former finance minister—replaced this month in a Cabinet shakeup—believed the parallel market was largely responsible for an improvement in government finances during the first half of 1984, according to the US Embassy. Tax revenues were 29 percent higher than those in the same period in 1983, and import taxes doubled. 25X1

To address the country's still serious fiscal imbalances, the government passed a controversial economic stabilization package in May 1984 based on IMF recommendations. The law calls for reduction of the budget deficit through higher taxes, broad spending cuts, and more central government control over the finances of parastatal institutions:

- New tax measures include a 5-percent customs fee for imports, a tax on legal transactions, and a broadening of the sales tax.

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- Budgets of the parastatals are to be cut and a new accounting system implemented to better monitor their finances.
- Liquidity in the banking system is to be reduced by restricting public-sector credit and raising reserve requirements. [redacted]

Considerable popular opposition to the stabilization package has surfaced. The strongest opposition has come from labor unions. Following congressional approval of the bill, the largest labor organization, the Confederation of Honduran Workers, called for a general strike on 20 June to protest the package. The strike was averted, however, when Suazo agreed to consider modifications to the tax increases. The package also has been criticized by influential businessmen, rival political parties, and the national press. Much of the criticism has centered on the tax increases. [redacted]

Government officials have expressed concern about the unusually strong public reaction to austerity. Suazo claims these unpopular measures play into the hands of local Communists trying to destabilize the political situation. The Communist Workers' Labor Federation has led several small street demonstrations to exploit opposition to tax increases. The Suazo administration appears to understand the need for economic reforms, but US Embassy reporting indicates that Honduran officials resent conditions by the IMF and the United States for future economic support. [redacted]

Harder Next Steps

We believe difficult and politically costly steps still face the Suazo government before it makes a dent in the country's foreign payments problems. We agree with the IMF that a key change would be to establish a more realistic exchange rate for the lempira. The currency has been pegged at the rate of 1 lempira to US 50 cents for half a century and has become increasingly overvalued since 1980. The IMF plans to propose a 30-percent devaluation during the next standby period to eliminate the need for import and foreign exchange controls. Thus, for the government to come to terms with the IMF, it probably will have to agree to devalue the

Honduras: Foreign Trade by Country, 1982 *Percent*

25X1

	Imports	Exports
Total	**100.0**	**100.0**
United States	39.8	52.3
Western Europe	13.0	27.8
CACM countries	12.0	7.2
Japan	6.3	6.2
Other	28.9	6.5

[redacted] 25X1

lempira before the November 1985 national elections. Moreover, the IMF has informed Honduran leaders that some type of exchange reform will have to be implemented before negotiations for a 1984 standby can start. The Fund has indicated that an expansion of the parallel exchange market would be acceptable as an interim measure. [redacted] 25X1

25X1

Devaluation is strongly opposed by most Honduran leaders, however, because it would trigger immediate price hikes in this import-dependent economy. Government officials are sensitive to the likely public protests a devaluation would cause and have expressed to US Embassy officials their fear of provoking disturbances. Opposition politicians are likely to exploit a devaluation by claiming it represents a capitulation to US pressure that disregards Honduras's sovereign interests. [redacted] 25X1

25X1

Near-Term Outlook

The decline in economic activity appears to be bottoming out, and a slight recovery is likely through 1985. Demand for Honduran agricultural exports should pick up a bit with continued recovery in industrialized countries, particularly the United States. Banana production should rebound from the wind damage suffered in 1983, and coffee exports will rise as a result of a 4-percent increase in the quota set by the International Coffee Organization and higher prices for nonquota coffee exports. Regional turmoil probably will continue to discourage investment and spur capital flight. Nonetheless, the stabilization package should increase domestic credit available to the private sector somewhat by reducing allocations to the parastatals. Even if, as we expect, Honduras achieves 1-percent economic growth this year, per capita income will continue to fall because Honduras's population growth of 3.5 percent is among the highest in Latin America. We project that inflation will remain in the 8- to 10-percent range through 1985. [redacted] 25X1

We believe a devaluation, which would improve the investment climate and trade prospects, will continue to be avoided by the Suazo administration. Opposition to exchange-rate reform is unlikely to diminish as Suazo and other Liberal Party members look ahead to the 1985 elections. The government probably will have to proceed with an economic strategy that excludes an IMF program through 1985, because we doubt the IMF will budge on the exchange-rate issue. [redacted] 25X1

Honduran officials will turn increasingly to the United States for economic support. According to the US Embassy, Honduran leaders believe that they need and deserve more US economic assistance for their support of US policy. US aid—total economic aid from the United States is scheduled to rise from $170 million in fiscal year 1984 to $240 million in 1985—could enable Honduras to avoid further import restrictions and might help prevent another decline in per capita GDP. [redacted] 25X1

[redacted] 25X1

Sudan: Nimeiri's Financial Mess [redacted] 25X1

Sudan is doomed to financial crises for the next few years and will remain heavily dependent on Western and Arab aid. Khartoum's resort in the mid-1970s to foreign commercial borrowing for development projects and to cover foreign balance-of-payments shortfalls resulted in an unmanageable debt by 1978. Even with IMF financing and debt reschedulings by the Paris Club, Sudan is chronically and desperately short of foreign exchange for imports and to service its $9 billion foreign debt. We believe that President Nimeiri will come under increasing pressure from donors to temper his controversial Islamization program and to implement policies that restore political and economic order. [redacted]

Sudan: Balance-of-Payments Financing *Million US $*

	1981	1982	1983
Current account balance	**−916.5**	**−1,268.5**	**−915.5**
Official transfers (grants)	122.0	173.5	305.0
Direct investment	20.0	50.0	70.0
Net medium- and long-term loans	412.8	587.7	320.0
Net IMF credit	289.9	55.4	190.6
Errors and omissions	158.9	130.8	128.8
Net change in reserves	87.1	−271.1	98.9

[redacted] 25X1

Growing Importance of Aid

In the early 1970s, Sudan's foreign payments were buffeted by unfavorable terms of trade resulting from soaring oil prices and low prices for Sudan's narrow mix of agricultural exports. To finance its current account deficits—and to push agricultural development intended to make Sudan the bread-basket of the Middle East—the Sudanese Government increasingly resorted to foreign borrowing. By 1978, known external debt exceeded $2.0 billion, debt service payments were taking about 20 percent of the country's annual export earnings, and arrearages totaled about $250 million. In 1981, Sudan's estimated debt was more than $5.0 billion and the debt service ratio was nearly 60 percent. [redacted]

Arab support fell off sharply after 1976 because of lack of confidence in Sudan's fiscal and monetary management. Lacking sufficient funds, Khartoum in mid-1978 agreed to a three-year, $450 million Extended Fund Facility agreement with the IMF. Subsequently, Arab aid commitments rose sharply—averaging close to $400 million annually in 1979-80. In return for renewed Arab aid, Nimeiri tempered his support for the Egyptian-Israeli peace agreement. [redacted] 25X1

Bilateral loans and grants continued to be an important part of Western aid to Sudan. Bilateral economic aid from OECD countries increased from $180 million in 1979 to about $350 million in 1980. Major donors were the United States, West Germany, the Netherlands, and the United Kingdom. [redacted] 25X1

Debt rescheduling under the Paris Club of creditors took on increased importance as Sudan's debt problems worsened. In 1979, the Paris Club rescheduled almost $500 million of Sudan's debt, easing interest payments and lengthening repayment periods. [redacted] 25X1

25X1

Current Dependence on Foreign Help

Recurrent foreign payments problems have made IMF agreements, debt reshedulings, and requests for supplemental donor aid an integral part of Sudan's financial life. Agreements reached with the IMF since 1979 have given Sudan access to about $1.1 billion in loans. Annual meetings of donors in Sudan's Consultative Group have resulted in high levels of economic aid commitments. In 1982, for example, economic aid to Sudan averaged about $30 per capita, ranking it high among LDC recipients. Several countries—including West Germany, the United Kingdom, and the Netherlands—now give interest-free loans, while most other transfers are a combination of grants and low-interest loans. Over the last five years, Western creditors have rescheduled $1.4 billion of Sudan's $9 billion debt. Arab governments have also rescheduled payments on bilateral loans to Sudan.

More recently, donors have been trying to impose order on Sudan's petroleum purchases. In the past, foreign exchange shortfalls have periodically caused oil shortages that have disrupted the economy and angered ordinary citizens. Donors are concerned that Sudan has been paying premimums of up to 40 percent or $60-80 million annually for oil because of its credit rating. Over $100 million in aid—mainly from the United States and Saudi Arabia—will be earmarked for an oil fund, with donor commitments as collateral for oil purchase credits. The fund should be operating later this year.

The Arab Connection

Saudi Arabia has continued its bilateral aid even though Khartoum is often in arrears on repayments of Saudi loans. Riyadh has maintained its support partly because it views Sudan as a bulwark against Communist advances in the region. Saudi Arabia supplements its cash assistance with ad hoc shipments of oil and reportedly buys sorghum from Sudan at above-market prices.

Sudan: Economic Assistance From Major Donors *Million US $*

	1981	1982	1983 [a]
Western donors			
United States	104.0	175.0	165.0
France	62.0	130.1	40.0 [b]
West Germany	79.2	41.3	55.0 [b]
Netherlands	34.8	26.4	30.0 [b]
United Kingdom	53.3	27.2	10.7
OPEC [c]			
Saudi Arabia	160.0	80.0	178.0
Kuwait	NEGL	0	NEGL
UAE	40.0	50.0	0
Multilateral			
IDA (World Bank)	64.8	84.9	NA
EC	45.5	40.9	45.0
UNHCR	18.7	24.9	NA

[a] Estimated.
[b] Projected disbursement.
[c] Excludes loans from country development funds.

25X1

25X1

During the last five years, however, the Arab governments, especially the Saudis, often have made their aid contingent upon Sudan's adherence to an IMF program. Despite overall aid cutbacks, Riyadh is generous to fellow Muslim client states but has been increasingly unwilling to extend grants or loans without promises of economic reform. In 1980, for example, Riyadh delayed a $50 million loan payment to Sudan, and linked disbursement to Sudan's adherence to its IMF agreement. Some other Arab donors have been reluctant to dole out cash, preferring to tie aid to specific development projects. 25X1

25X1

Some of the smaller Persian Gulf donors have increasingly hesitated to aid Sudan because of what they perceive as gross mismanagement of the economy and aid funds. 25X1

25X1

[redacted] The UAE made no commitments to Sudan last year and is not expected to make any this year. During a financing crisis last month, Kuwait, which manages both its own development fund and the Arab Fund, turned aside requests to help close Sudan's projected balance-of-payments gap. According to Embassy reporting, Kuwait has not attended recent Consultative Group meetings and has sought joint Arab action to restrict assistance because of Khartoum's mounting arrears. Sudan owes about $500 million to Kuwait and its various funds, according to Embassy reporting. [redacted]

Periodic Crises Continue

Khartoum still fails to meet its financial obligations, despite the generosity of its donors. Sudan is operating under a $100 million IMF standby agreement reached in June. The agreement was in doubt until the last minute because Sudan was $25 million behind on repayments to the Fund and was having difficulty with its projected 1984 balance-of-payments gap. The scramble to secure adequate financing resulted in supplemental loans from major donors including the United States, and probably a decision by Saudi Arabia to reprogram some of its project aid into cash assistance. This latest crisis—the third in about a year—was finally resolved when a US bank provided the bridge financing necessary to pay the IMF arrearages. The bank was to be repaid from the first standby tranche—about $20 million. [redacted]

What Happens Next

Sudan is unlikely to wean itself from foreign financial support for the next several years. Exports continue to be dominated by cotton, sorghum, and gum arabic, prices for which are unlikely to rise sharply in the near term. Oil provides the only glimmer of hope, but foreign oil companies probably will not make significant headway until a military or political solution is found to end the southern insurgency. [redacted]

25X6

Some major donors are pressing Nimeiri both to resolve the southern problem and to moderate his efforts to Islamize the Sudanese economy and society—including the Christian and animist south. Some European donors—particularly the Netherlands—have increasingly criticized human rights abuses, especially amputations as criminal punishments. According to Embassy reporting, The Hague has indicated its intention to redirect some of its undesignated project aid to another country if the Nimeiri government does not improve its human rights record. [redacted] 25X1

25X1

Sudan's financial problems will be further complicated by Nimeiri's determination to Islamize the banking sectors and to substitute portions of Sudan's current tax system with the *zakat* (Islamic tax). The Sudanese Government has adopted both Islamic measures but has not issued clear instructions on how implementation is to occur. Uncertainty about the direction of the banking system and fear of Islamic punishment has already prompted bankers to reduce domestic banking significantly. The announced imposition of the *zakat*—about 2.5 percent of income—and the rescinding of the current system of income tax collection have cast doubts on Sudan's ability to meet IMF targets for government revenues and maintain its Fund program. Should the IMF agreement collapse, donor aid programs will be further jeopardized. [redacted] 25X1

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